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C O N F I D E N T I A L SECTION 01 OF 02 BAGHDAD 002973

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SUBJECT: SOUTHERN IRAQ OIL AND GAS SITUATIONAL ASSESSMENT,
PART 1: IRAQI COMPANIES OPTIMISTIC

REF: BAGHDAD 2899

Classified By: Economic Minister Counselor John Desrocher for reasons 1
.4 (b) & (d)

11. (C) Summary: In the run-up to what promises to be an historic expansion of Iraqi oil and gas production, Econoffs visited Basrah-based Southern Oil, Southern Gas, and Southern Refining companies to assess their preparations and solicit their views. Southern Gas seemed upbeat but ill-prepared for the massive investments to come, appearing to rely instead on the planning and financing that international companies, particularly Royal Dutch Shell, will bring to the table. Southern Refining was much more organized, with specific infrastructure projects planned and ready to move forward, including expanded capacity and new catalytic cracking technologies. Their challenge is obtaining billions of dollars in financing for these projects, while facing 2010 budget cuts from Baghdad. Southern Oil was the most optimistic and had the most well-defined plans, owing to their ongoing negotiations with BP/CNPC and preparations for similar engagements with ENI and ExxonMobil. The optimism for planned oil sector expansion was a gratifying change from the recent past, but the lack of specific plans (for gas) or adequate financing (for refining) highlight some of the key challenges that will face the GOI as it attempts to keep pace with what could be an extremely rapid growth cycle driven by world-class international oil companies. End Summary.

12. (SBU) On October 24-26, econoffs traveled to southern Iraq to assess the current state and future potential of Iraq,s southern oil and gas facilities and export infrastructure before the implementation of pending development and production contracts with international oil companies. We met individually with the Directors General who head the Oil Ministry,s three operating companies in southern Iraq: South Oil Company, South Gas Company, and South Refinery Company. We also toured the Shuaiba Oil Refinery (Iraq,s third largest refinery after Baiji and Daura) and Zubair Oil Gas Separation Plant (GOSP) #1.

South Refinery Company: Has Plans but No Funds

13. (SBU) South Refinery Company (SRC) Director General (DG) Theair Ebrahim Jaber said the refinery is currently operating at or near its capacity of 140,000 barrels per day (contrary to other refineries in the north of Iraq that are often undersupplied with feedstock and therefore run below full capacity). Theair expressed concern over SRC,s continuing problems with water used in refinery operations that is drawn from the Shat Al-Arab and which has now reached six times its usual salinity, due in large part to flood irrigation techniques and intrusion of salt water from the Arabian Gulf

into the Shatt al-Arab (reftel). This highly saline water is overwhelming the desalinization equipment in Shuaiba Refinery and accelerating the corrosion of refinery equipment. Theair said he had considered adding additional reverse osmosis units to deal with the added salinity, but instead now plans to seek a "permanent" solution by building a separate desalinization plant. He also confirmed that plans are on track to expand refinery capacity from 140,000 barrels/day to 210,000 barrels/day in 2011, and to add a Fluidized Catalytic Cracking (FCC) unit. (Note: an FCC breaks down heavy oil molecules into lighter, higher value-added molecules, resulting in higher distillate production per barrel and less residual heavy fuel oil, or HFO, per barrel.) Theair lamented government budget cuts for 2010 that will slow down capital projects.

South Oil Company: Confident About Development Prospects

14. (C) South Oil Company (SOC) DG Dheyaa Jaafar Hyjam said that although SOC employees and the local community were initially concerned, they now welcomed international oil company (IOC) assistance in developing southern oil fields. Dheyaa stated that he has been in close contact with the Basrah Provincial Council, which reportedly had been seeking a delay in the start of IOC investment until the Council received additional information and assurances about the developments. According to Dheyaa, a few Council members remained implacably opposed to IOC investment, but most now welcomed the employment and development it could bring to Basrah. Similarly, Dheyaa said he and his staff had

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responded to concerns raised by the legal advisor's office of the Council of Ministers regarding the first contract Basrah-related contract with BP/CNPC. He confirmed reports that the advisor had posed 65 observations and questions, but said SOC had adequately addressed each of the legal advisors, questions, allowing the Council of Ministers to approve the contract. Dheyaa was optimistic that the contracts with IOCs -- challenged by some in the Council of Representatives (CoR, the Iraqi Parliament) as illegal without CoR approval-- would withstand scrutiny and be honored by whatever administration wins election in January 2010.

15. (C) When asked what concerns international oil companies have voiced about doing business in southern Iraq, the DG Dheyaa said two key issues were security and oil-related infrastructure, especially export infrastructure. Dheyaa recognized the vital importance of the Southern Export Redundancy Project (SERP), which would replace and then expand Basrah's subsea export pipelines, and is pressing the Ministry of Oil to accelerate the project. (Comment: Dheyaa's effort faces two significant problems: first, many SERP infrastructure parts involve long-lead times, requiring 12-18 months to fabricate. Second, accelerating the project would require an additional USD one billion in MoO finance costs in the coming year. End comment.) Dheyaa said the Oil Ministry's State Company for Oil Projects (SCOP) will add on-shore pipelines between Pump Station 1 (PS1) and the Al-Faw Metering and Manifold Station and between Zubair Pump Station and Al-Faw. The SCOP will also rehabilitate PS1, Zubair, and Tuba pump stations so that southern oil export infrastructure south of PS1 (southern Iraq's largest pump station) can handle, initially, up to 6.0 million barrels/day and, eventually, up to 8.0 million barrels/day.

16. (C) DG Dheyaa pointed out that oil field development was continuing even without international oil companies. As examples, he mentioned that 20 new wells had been drilled in Rumaila and 15 in Zubair and that Weatherford International was close to finishing a project to rehabilitate existing wells in Rumaila. Both the SOC DG Dheyaa and South Gas Company (SGC) DG Ali Hussain Khudhier stated their intentions

to hire hundreds of new employees in conjunction with the new contracts with international oil companies. (For a more detailed readout of these and other comments, see Basrah 59.)

South Gas Company: Betting Heavily on Shell

17. (C) South Gas Company Director General Ali Khundhier was upbeat but somewhat vague regarding prospective developments in the gas sector. Asked how the potentially significant increases in production of associated gas from first bid round oil fields would be handled, Ali brushed the concern aside noting that all associated gas from first bid round fields would be handled by Shell. (Comment: For more than one year, Royal Dutch Shell has been negotiating a contract to capture, process, and transport natural gas produced in Basrah. The deal, originally due to be signed in September, has still not been concluded. Ali's faith in a prospective Shell deal stands in stark contrast to recent comments to Embassadors by MoU Deputy Minister Ahmad al-Shamma, who called the Shell gas deal "dead." Even if the Shell deal is concluded, questions remain concerning how oil and gas from the same field (traditionally exploited or developed by the field operating company) will be handled by two separate companies. End comment)

18. (C) Ali was similarly optimistic, but unfocused, regarding any associated gas that might be produced from second bid round fields (Note: The Second Bid Round takes place December 11-12 and includes several fields in southern Iraq. End note) Asked whether such gas would be used for electricity generation, liquefaction for LNG, fertilizer, or petrochemicals, Ali embraced all these options, but showed no sign that any significant planning had been done towards any projects. Asked about the infrastructure requirements for handling additional gas, Ali made a quick calculation in his head regarding new facilities -- not at all the kind of carefully scoped-out plan we expected in light of the proposed expansion of production. To a surprising degree Ali seemed comfortable with leaving much of the planning and execution in the hands of Shell, at least for now.

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